



# Economic Update

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Volume 4, Number 5

16 June 2005

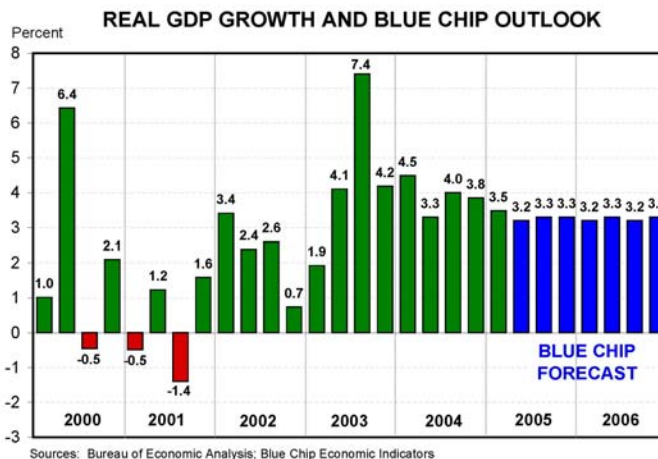
## U.S. Economy on 'Reasonably Firm Footing'

The U.S. economy appears to have settled into a steady, moderate growth rate roughly consistent with its long-run potential for expanding without touching off higher inflation pressures – what economists call the “potential” growth rate. Private forecasters expect real gross domestic product [GDP] to grow at an annual rate of between 3 percent and 3½ percent through the end of 2006, and the unemployment rate to continue near 5 percent. Federal Reserve Chairman Greenspan, in recent congressional testimony, said: “[T]he U.S. economy seems to be on a reasonably firm footing and underlying inflation remains contained.”

### Recent Data

Available data generally are consistent with ongoing sustained moderate growth, although observed results can bounce around from month to month or quarter to quarter, and some sectors are performing better than others.

- *Real gross domestic product* grew at a 3.5-percent annual rate in the first quarter of this year – an upward revision from the advance estimate of 3.1 percent. Real GDP now has been growing for 14 consecutive quarters, and at more than a 3-percent rate for 8 straight quarters. Over the past 2 years, real GDP has grown at a 4.3-percent annual rate on average.
- *Nonfarm payroll employment* increased by 78,000 jobs in May. This was lower than expected, and down from the 274,000 jobs gain in April; but such one-month “snapshot” observations often fluctuate, and are not always accurate measures of the true ongoing performance. Other data indicate the underlying performance of the labor market is stronger than that number by itself would suggest.
  - Payroll employment is up by 3½ million over the past 2 years – an average of 146,000 jobs per month. Over the past 6 months – even including the May number – payroll employment gains have averaged 176,000 jobs per month.
- The unemployment rate is down to 5.1 percent, a relatively low level by historical standards and the lowest since September 2001.
- Initial weekly claims for unemployment insurance are running at around 330,000 – a level typically consistent with payroll jobs gains of around 150,000 to 200,000 per month.
- The preliminary month-to-month payroll jobs numbers are volatile and subject to substantial revision. Historical evidence shows the first-announced “real time” estimate by the Bureau of Labor Statistics ultimately is revised by plus or minus 90,000 on average; a 6-month average is subject to revisions about half as large. Multi-month averages are more reliable measures of underlying jobs performance.
- The most recent *Manpower* employment outlook survey stated: “U.S. employers have reported healthy hiring expectations since the second quarter of 2004. This pattern mirrors a period in the late 1990s, when employers were consistently optimistic about hiring for more than 2 years.”



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- *Industrial production* – the output of the Nation’s factories, mines and utilities – rose 0.4 percent in May, following a 0.3-percent decline in April. Manufacturing industrial production rose 0.6 percent in May, following small declines in March and April. The declines had prompted concerns of a manufacturing slowdown. A better interpretation is that manufacturing activity is now expanding at a more moderate pace: over the past year, manufacturing production has increased 3.4 percent – a reasonable rate of growth – but down from the prior year’s increase at a 6 percent rate.
- *Housing markets* continue to show robust activity. Historically low mortgage rates and ongoing growth in personal income are contributing to ongoing strong performance of housing starts, sales, and prices. Fed Chairman Greenspan recently commented on his observations about housing market “froth”: “exceptionally low interest rates on 10-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of homebuilding and home turnover, and especially in the steep climb in home prices. Although a bubble in home prices for the Nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.”

### Long-Term Interest Rates

Fed Chairman Greenspan earlier this year referred to the low long-term rates as a “conundrum.” Some have interpreted the lower rates as an indication of weaker growth, a view Greenspan labeled “probably not correct.” Alternative explanations include:

- *Federal Reserve credibility*: Financial markets view the Fed’s increase in interest rates over the past year – and the prospects for additional increases this year – as signaling continued vigilance against inflation. The Fed earned this credibility through prior rate increases in the 1987-89 and 1994-95 periods, and it is resulting in keeping down long-term rates now even as short-term rates rise. The increase in short rates signals maintained low inflation, and therefore low nominal interest rates over time.
- A “*soft landing*”: The economy is returning to its non-inflationary “potential” rate of real growth with a “soft

landing” – that is, without evidence of overshooting into inflationary excesses. U.S. real GDP growth has slowed from an underlying rate of growth in the 4-percent to 5-percent range during 2003-04 to the current projections of around 3 percent to 3½ percent during 2005-06 (see table below). The projection is still for solid, sustainable growth for this stage of the business cycle – but not excesses in inflationary pressures.

- *Shrinking Federal budget deficit?*: Data so far this year have shown higher-than-expected Federal tax revenue – up by 15½ percent through May, compared with last year – reducing the deficit by more than previously projected. This pattern is similar to that of the 1996-98 period, when revenue surged and Federal budget deficits fell sharply, accompanied by declines in long-term interest rates and in the “yield curve” spread (the difference between long- and short-term rates). The improvement in the deficit outlook over the past year and a half is on track to be one of the largest in history.

### Blue Chip Economic Outlook, June 2005

	2004.4	2005.1	2005.2	2005.3	2005.4	2006.1	2006.2	2006.3	2006.4
	----- Actual -----		----- Projection -----						
Real GDP Growth	3.8	3.5	3.2	3.3	3.3	3.2	3.3	3.2	3.3
Unemployment Rate	5.4	5.3	5.2	5.2	5.1	5.1	5.1	5.1	5.1
CPI Inflation	3.4	2.5	3.9	2.1	2.4	2.4	2.5	2.3	2.4
3-month Treasury Bill	2.0	2.5	3.0	3.4	3.7	3.9	4.0	4.1	4.2
10-year Treasury Note	4.2	4.3	4.3	4.4	4.6	4.8	5.0	5.0	5.0

### Blue Chip Forecast

The “consensus” economic forecast from the June *Blue Chip Economic Indicators* (see table) shows real GDP growth growing at around a 3¼-percent annual rate through the end of 2006. This moderate rate of growth is roughly consistent with the “potential” rate of non-inflationary real growth, and as a result, the unemployment rate is shown to remain relatively unchanged at just over 5 percent in the forecast.

Consumer price index [CPI] inflation is projected to moderate, in the 2-percent to 2½-percent range. Interest rates are expected to rise gradually through early next year and then stabilize.

All told, the forecast shows a sustained expansion with low unemployment, inflation, and interest rates.

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